Market Mechanisms Proposals for Federal Student Loans

Market mechanisms reasonably might be applied to the following three aspects of the federal student loan programs: borrower rates, lender yields, and servicing arrangements on government-held loans. The following recommendations indicate whether and how market mechanisms might be applied in each of these three areas.

1) Borrower rates. Borrower interest rates in the various federal student loan programs should continue to be set in federal legislation to protect the most at-risk borrowers from excessive market forces. The rate on all new loans also should be uniform for all borrowers in school and in repayment. One possible budget-neutral configuration would be to set the uniform rate at the prevailing Treasury bill plus 2 percent, with a cap of 8.25 percent. In addition, all borrowers should have the option to consolidate and refinance their federal student loans at the same terms and conditions that apply for new loans.

2) Lender yields. The amount of federal payments to lenders, which in combination with borrower payments determine lender yield, should not be set in legislation. Instead, the government each year should establish a schedule of payments to compensate lenders for the difference between the borrower rate and market-based yields when borrower interest rates fall below the statutory borrower cap. The existing Special Allowance Payment (SAP) should still apply when the borrower rate formula exceeds the statutory cap.

It would be best if these federal supplemental payments to lenders were made only once, either when the loan is initially made, or, for existing loans, when and if the loan is consolidated and refinanced. The amount of this single supplemental payment should be determined on the basis of: a) the prices paid for a modest amount of existing Direct Loans that the government would auction each year to help determine underlying market yields, and b) information the federal government would collect on the terms and conditions of previous and current secondary market transactions of federal student loans.

A committee appointed by the Secretaries of Education and the Treasury would use the data collected as part of a) and b) above to determine the amount of the single supplemental payment to lenders each year. These payments to lenders could vary for different borrowers based on the institution attended and/or they could vary for lenders based on lender size, student loan activity, or any other characteristics deemed relevant.

3) Servicing on Government-Held Loans. The government should use an auction of a portion of Direct Loans entering repayment to determine the price to be paid for servicing all government-held loans, except loans of those borrowers who are repaying on an income contingent basis. Income contingent accounts should continue to be serviced by the government directly or through contracted servicers). To encourage better servicing on government-held loans, this auction should determine a price that would be calibrated on the amount of loans that servicers collect, rather than the more traditional arrangement in which payments are based on the face value of the loans serviced. As in the case of the single supplemental payments to lenders proposed above, the amount paid to servicers could vary on the basis of the type of institution the borrower attended or other loan or borrower characteristics deemed relevant and nondiscriminatory.

Arthur M. Hauptman – 31 May 2000